

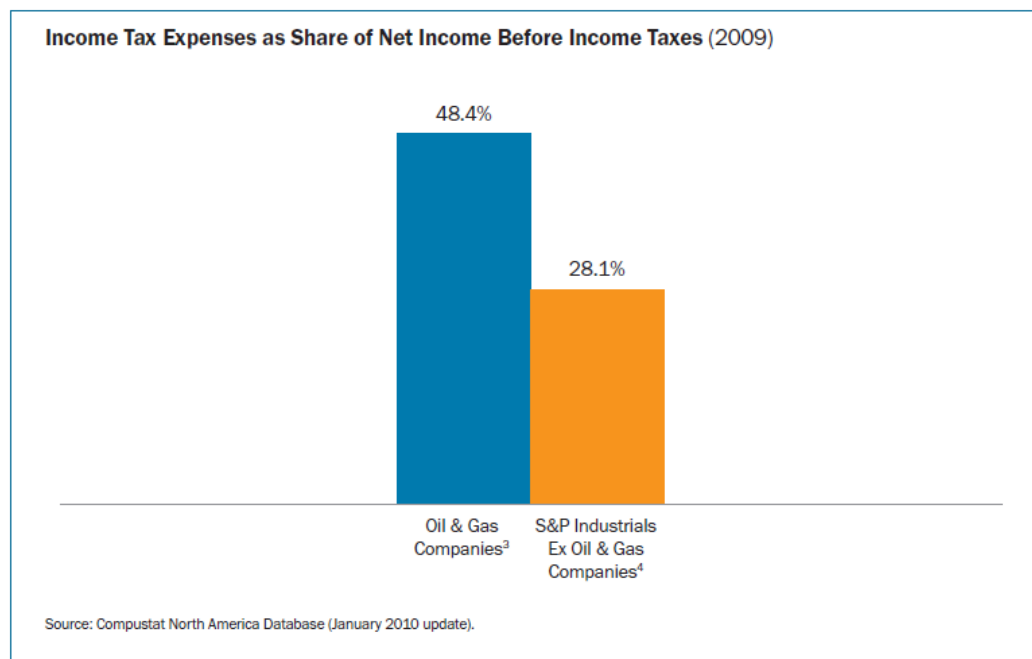


# COGA | Colorado Oil & Gas Industry Tax Whitepaper

The Colorado oil and gas industry is no stranger to taxes. Like other industries, we understand and respect the process by which states generate revenue to develop and maintain crucial services, infrastructure, and jobs. We know that taxes matter, and without them, many of the departments that guide our industry would suffer. However, the oil and gas industry carries the heaviest tax burden amongst industries. While we understand the need to remunerate the communities within which we operate in, we must remain competitive. By encouraging development, taxes paid on production would increase, thus providing the state with much needed tax revenues.

## Industry Taxes Comparison

The oil and gas industry paid 48% of net income in 2009 income tax. The rest of the S&P Industrials paid only 28.1% of net income in taxes. Thus creating a 20 point gap between the oil and gas industry and the other S&P industrials. (API 2010)



## Overview of Current Colorado Tax Structure & Rates

In effect, Colorado levies three direct taxes on production – the first by the county where the production occurs, the second by the state, and the third by the Colorado Oil and Gas Conservation Commission (COGCC). Some of the tax paid at the local level can be deducted from the state severance tax to provide revenues and encourage public investment and job creation in energy-producing counties.

## Key Definitions

- State severance tax: a tax on what is “severed” from the earth, i.e. oil, gas, minerals, up to 5%
  - 2% for annual taxpayer production under \$25,000
  - \$500 + 3% for \$25,000 to \$100,000
  - \$2,750 + 4% for \$100,000 to \$300,000
  - \$10,750 + 5% for production over \$300,000
- County ad valorem tax: a form of property tax; in Colorado, local governments tax oil and gas production at an assessed value of **87.5 percent**. (By comparison, residential property is assessed at just under 8 percent of value, commercial property is assessed at 29 percent.) The purpose of the local ad valorem tax is to ensure that revenues stay in the local communities that have mineral development operations. Colorado’s Revised Statute (CRS) 39-7-102 establishes that in the case of oil properties: “the assessor shall value such oil and gas leaseholds and lands for assessment, as real property, at an amount equal to eighty-seven and one-half percent of the selling price of the oil and gas sold therefrom during the preceding calendar year...”
- The COGCC levies a **.7%-1.5%** tax on production.
- In Colorado, severance tax is progressive; the rate increases with the volume of sales.
- Colorado statute exempts stripper well oil production from severance tax (Colorado’s Revised Statute 39-29-105(1)b): “except that oil produced from any wells that produce fifteen barrels per day or less of oil and gas produced from wells that produce ninety thousand cubic feet or less of gas per day for the average of all producing days during a taxable year.
- Federal/state royalties are generally **12.5%** of production value.
- Colorado corporate income tax rate is **4.63%**.
- Sales taxes are levied on purchases of both inputs and equipment needed for capital improvements; the average rate for Colorado is **4.3%** (LECG Dec. 2008).
- Property tax on machinery, equipment, and buildings is also assessed at the **29%** commercial ad valorem rate, and unlike ad valorem tax on production, this tax cannot be credited against the state severance tax.

Colorado’s revenue for fiscal year 2009 from the business community is comprised of the following (Ernst & Young 2010):

- 40.4% property tax
- 28.0% sales tax
- 7.0% excise and gross receipts
- 3.8% corporate income
- 4.4% unemployment insurance tax
- 8.0% individual income tax
- 8.4% license and other (includes severance tax)
- Total: 100.0%

## Distribution of Severance Revenues

In 2009, 96% of severance tax revenues in Colorado came from the oil and gas industry. Half goes to the State Severance Tax Trust Fund and half into the Local Government Severance Tax Fund. The revenue in the State portion funds the Oil and Gas Conservation Commission, the Colorado Geological Survey, the Division of Minerals and Geology, and the Water Conservation Board, as well as various water conservation and development projects around the state. The revenue in the local portion is returned to local governments impacted by oil, gas, and mineral production to help them provide needed services.

### Severance Tax Revenues Oil and Gas (\$ Millions)

Year	Severance Revenues from Oil and Gas (\$ Millions)	Severance Tax Revenue Total (\$ Millions)	% of Total Severance Revenues from Oil and Gas
2000	\$24	\$32	77%
2001	\$54	\$62	88%
2002	\$49	\$57	86%
2003	\$24	\$32	74%
2004	\$107	\$116	92%
2005	\$135	\$146	93%
2006	\$202	\$212	95%
2007	\$126	\$137	92%
2008	\$140	\$151	92%
2009	\$274	\$285	96%

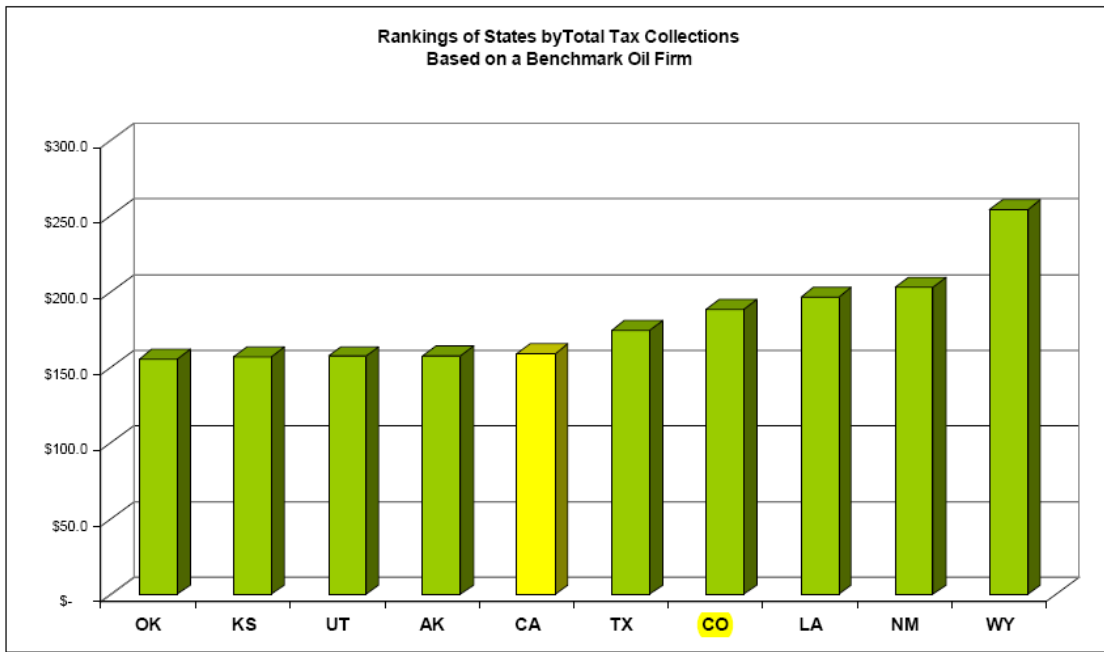
(Compiled from DOLA – Mineral Revenues to the Public Sector. March 2010)

The dilemma which exists for all states that significantly rely on oil and gas tax revenue is that high prices and production volumes create windfall revenues in some years and poor prices or production volumes create revenue shortfalls in other years.

#### **Comparison of Colorado Oil and Gas Industry with Other States**

It is not a simple exercise to compare the total industry tax burden across states. The total tax burden on oil and gas companies depends on: the type of taxes imposed, the base of each tax, and the tax rate for each type of tax. Most states rely on some combination of severance tax, corporate income tax, property tax, and sales tax. Tax burden comparisons across states are complicated by the variety of tax programs and their differing responses to oil and gas price changes.

A LECG (December 2008) report created a benchmark oil firm and compared total tax burdens between the ten largest oil producing states. A separate LECG (July 2008) report created a benchmark oil firm and compared total tax burdens between nine western states at different oil prices. In each of these studies, Colorado tax burden was roughly in the middle high end; see charts below.

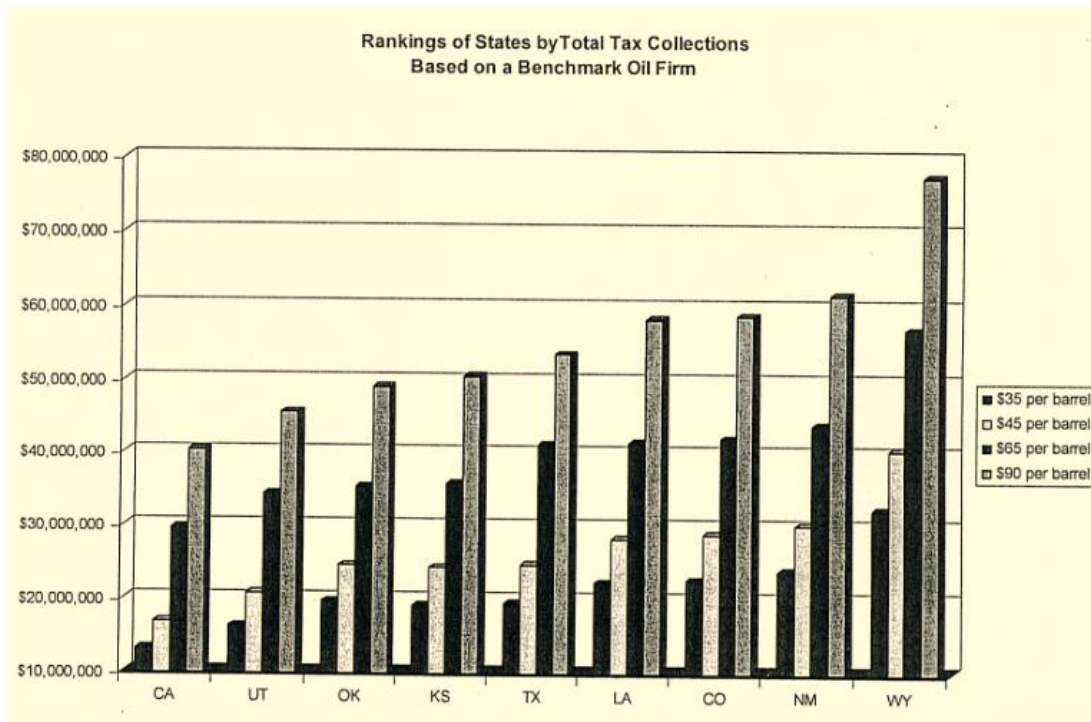


(LECG December 2008)

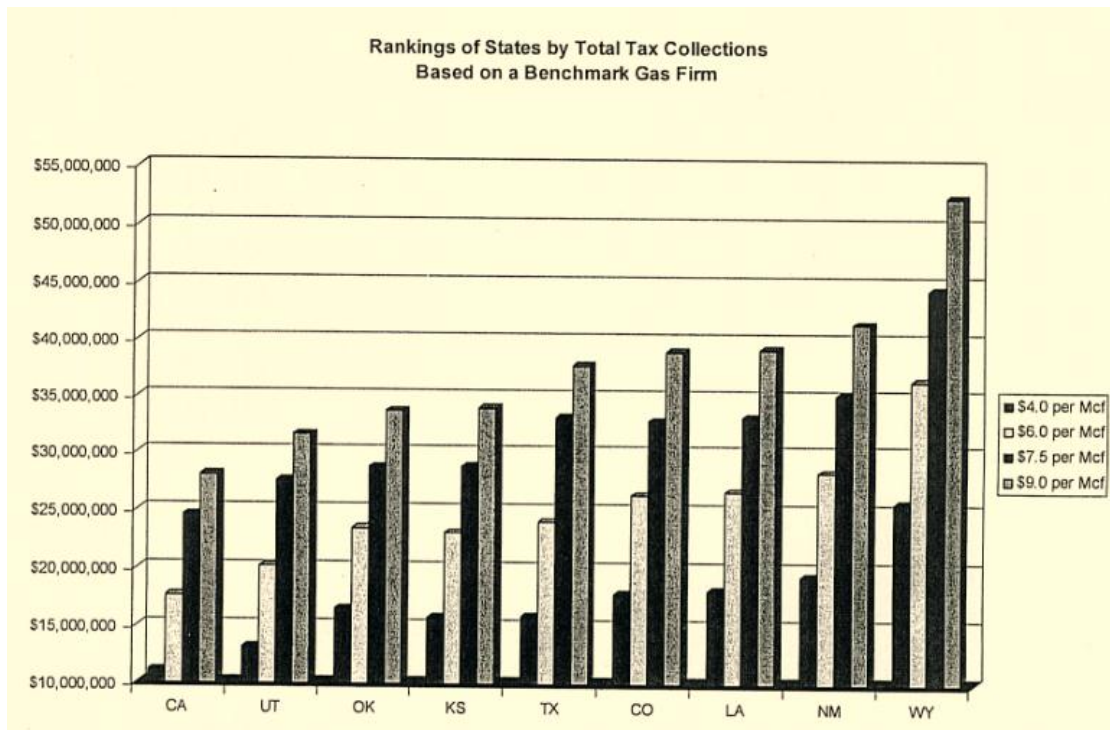
As Figure 1 indicates, the top ten oil-producing states can be divided into three groups:

1. Oklahoma, Kansas, Utah, Alaska and California – in which the tax burden is nearly identical.
2. Colorado, Texas, Louisiana and New Mexico - in which the tax burden is about 20% higher than in the previous group.
3. Wyoming, which has the second highest severance tax and a high property tax.

LECG did a prior study earlier in 2008 to examine Colorado's tax burden closer with eight other states. The results were similar.



(LECG July 2008)



(LECG July 2008)

As Figures 2 and 3 indicate, for all oil prices, Colorado has the third highest total taxes. For gas prices, Colorado has either the fourth or fifth highest tax burden depending on gas prices, consistently landing in the middle of the pack.

**Why the Ad Valorem Tax Credit is Important**

In Colorado, oil and gas equipment and property is subject to local ad valorem tax at an assessed value of 29% of market value, much like the equipment and property of all other businesses in the state. Unlike other businesses however, oil and gas production is also subject to local ad valorem tax at an assessed value approximately three times higher than any other property class (87.5% of market value). This same production is also subject to state severance tax and conservation taxes.

Recognizing that the production is being taxed multiple times, Colorado’s severance tax law allows some of the local ad valorem tax burden to be used to offset the severance tax. Local ad valorem rates range from approximately 4% to 15%. These rates combined with 5% severance tax means that production could be taxed up to 20% before it goes to market. The ad valorem tax credit is unique to Colorado because local taxes in other states are generally lower.

**Severance Tax Revenues Volatility**

Severance tax and ad valorem tax on production are driven by prices and volumes. Due primarily to recent price volatility, tax revenues from oil and gas production has been difficult to predict. Additional severance tax volatility occurs because of the timing of the ad valorem tax credit, which does not align the two taxes with the same production year. This misalignment magnifies the effect of price and volume fluctuations. The severance tax payment and reporting cycle are completed by the middle of the year following production. The ad valorem tax cycle, however, is not complete until two years after production. For cash basis tax payers, the ad valorem tax credit generated by a given year’s production is not available until the severance tax cycle that ends in the fourth year after that production. When prices and production are relatively flat, as is often the case with mature wells, the timing is of no real consequence. However, for new wells this timing difference can be significant.

New wells generally produce large volumes in the first couple of years, but experience dramatic declines until production begins to level off (a typical hyperbolic decline). This decline is often described as a bell-shaped curve. There is no ad valorem credit available for cash basis taxpayers to use against the severance tax associated with these high production years, resulting in both large ad valorem and severance tax burdens. When the ad valorem tax credit is finally available, it is based on the first year's production (a high volume / high tax year) and is applied to a different year's production (a lower volume / lower tax year), often eliminating the severance tax altogether.

The rules for accrual basis tax payers essentially shift the timing of the credit back one year, but still do not align the two taxes with the same production year.

This misalignment creates volatility and difficulty forecasting future revenues.

### **New Wells Increase State and Local Revenues**

As indicated above, new wells typically produce the highest tax revenues. This is due to high production volumes in the early life of a well and to timing alignment associated with ad valorem tax credit. Thus, policies which stimulate new well development will increase both severance and ad valorem property tax revenues.

### **The Stripper Well Exemption Allows Efficient Resource Extraction**

As wells mature, production volumes decrease dramatically. Long before all of the recoverable oil and gas has been recovered, the operating costs of these marginally producing (stripper) wells exceed the revenues they generate. Without Colorado's stripper well severance tax exemption, these wells would become uneconomic and would be shut in earlier than necessary. Replacing production from these wells would result in increased new surface disturbance from new wells. Nationally, stripper wells contribute approximate 17.8% of domestic oil production and 9% of domestic gas production (Oklahoma Marginal Well Commission).

### **Thanks for Allowing Colorado's Oil and Gas Industry to Bring Energy and Economic Solutions to Colorado**

Colorado's oil and gas industry is key to our state's economic and energy future. State budget problems cannot be resolved by any one industry alone. Any review of Colorado tax policy should be broad-based and comprehensive; Colorado levies all major forms of taxation in conjunction with severance tax. To ensure a strong economic recovery in Colorado, we must continue to attract oil and gas company investment to the state. That requires stable taxes and sensible regulations. We look forward to continuing to be a part of Colorado's energy and economic future.

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For more than 25 years, Colorado Oil & Gas Association (COGA) has promoted the beneficial, efficient, responsible and environmentally sound development, production and use of Colorado oil and natural gas. [www.COGA.org](http://www.COGA.org)